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Insolvency law

Mechanisms suitable for the insolvency of micro, small and medium-sized enterprises: the UNCITRAL Legislative Guide on Insolvency Law

Note by the Secretariat

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Background

1. At its forty-sixth session (2013), the Commission discussed issues related to the insolvency of micro, small and medium-sized enterprises (MSMEs) and requested Working Group V to conduct, at its session to be held in the first half of 2104, a preliminary examination of relevant issues, and in particular to consider whether the UNCITRAL Legislative Guide on Insolvency Law (the Legislative Guide) provided sufficient and adequate solutions for such enterprises. If it did not, the Working Group was requested to consider what further work and potential work product might be required, as noted above, to streamline and simplify insolvency procedures for such enterprises. Its conclusions on those issues were to be included in its progress report to the Commission in 2014 in sufficient detail to enable the Commission to consider what future work might be required, if any.[1]

2. The insolvency of MSMEs can raise concerns that may not be specifically considered in existing insolvency regimes. The smaller size of such enterprises makes them more vulnerable to the cash flow problems inherent in insolvency and less able to withstand complex, lengthy and expensive proceedings, leading some to suggest that resort to informal insolvency processes might be of assistance for MSMEs. In addition, many MSMEs are non-corporate entities or sole proprietorships, and do not enjoy legal personality or limited liability protection, and even where the MSME is a corporate entity, access to credit may be made subject to the granting of personal guarantees to creditors by the MSME owners or their relatives and friends. In such cases, MSME debt may accrue to individuals for life and may not be subject to discharge. Additional issues which may arise in the case of MSMEs are that it may be difficult to separate their business debt from their personal debt, and that the insolvency of non-corporate enterprises is usually regulated under personal insolvency regimes, even though it may be in relation to MSME business debt. Further, where personal insolvency frameworks must be relied upon to regulate MSME insolvencies, such frameworks may not provide temporary protection from creditors, nor allow for the proposal of a plan of reorganization.

3. Broadly speaking, the main concerns for MSMEs in insolvency in relation to the Legislative Guide can be said to consist of speed, flexibility and cost of the insolvency mechanism, as well as providing a fresh start for debtors through discharge. The following analysis of the Legislative Guide (using the headings and numbering used in the Guide) focuses on the extent to which these concerns may already be treated in the text and notes additional issues related to MSMEs that may touch upon certain aspects already addressed in the Legislative Guide. Finally, a list of issues which the Working Group may wish to consider in its discussion of this topic is provided.

[1] *Official Records of the General Assembly, Sixty-eighth Session, Supplement No. 17* (A/68/17), para. 326.

I. MSME issues as currently considered in the Legislative Guide

Introduction to the Legislative Guide

4. The Introduction to the Legislative Guide addresses the following issues of interest in the MSME context:

(a) The Legislative Guide focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, against a debtor, whether a legal or natural person, that is engaged in economic activity — i.e. natural persons are covered;[2]

(b) The non-legislative measures necessary for successful implementation of an insolvency regime may be of particular importance in the MSME context (adequate institutional infrastructure, organizational capacity, technical professional expertise and appropriate human and financial resources);[3] and

(c) The Legislative Guide assumes as a general principle that there is reliance on court supervision throughout the insolvency proceedings, but notes that alternatives to that approach may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by some other authority is preferred.[4]

Part one: Designing the key objectives and structure of an effective and efficient insolvency law

I. Key objectives of an effective and efficient insolvency law

5. In the Introduction to part one of the Legislative Guide, it is noted that a debtor (which would include MSMEs) and its creditors must be included in the scope of the legal mechanism regulating insolvency in order for them to be both subject to the discipline of the mechanism and to enjoy the protections provided by the mechanism. In addition, the Legislative Guide draws a distinction between formal insolvency proceedings, which are those commenced under the insolvency law and governed by that law, and informal insolvency processes, which are not regulated by the insolvency law and will generally involve voluntary negotiations between the debtor and some or all of its creditors. The Guide also observes that the effectiveness of such voluntary negotiations depends on the existence of an insolvency law, which can provide indirect incentives or persuasive force to achieve reorganization.[5]

6. It should also be noted that timeliness and efficiency, two of the issues most critical in MSME insolvencies, are included as key objectives in establishing and developing an effective insolvency law.[6]

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[2] UNCITRAL Legislative Guide on Insolvency Law, Introduction, para. 1.
[3] Ibid., para. 5.
[4] Ibid., para. 7.
[5] UNCITRAL Legislative Guide, part one, chapter I, paras. 1-2.
[6] Ibid., paras. 8-9 and recommendation 1(e).

II. Mechanisms for resolving a debtor's financial difficulties

B. Voluntary restructuring negotiations

7. Voluntary restructuring negotiations (VRNs) are included in the Legislative Guide as a mechanism for resolving a debtor's financial difficulties and an alternative to formal reorganization proceedings under the insolvency law. These allow creditors to negotiate with each other and with the debtor to restructure the debtor, with or without rearrangement of the financing. While the use of VRNs has been generally limited to cases of corporate financial difficulty or insolvency in which there is a significant amount of debt owed to banks and financiers, such mechanisms could be adapted for MSMEs and introduce flexibility into an insolvency regime.[7]

D. Administrative processes

8. The Legislative Guide also makes reference to, but does not discuss in detail, the use of administrative processes, or semi-official "structured" forms of insolvency processes, that have been developed in a number of crisis-affected jurisdictions to deal with systemic financial problems within the banking sector. Although these processes are complex and involve the development of special rules and regulations that would not be directly applicable to the MSME context,[8] they could provide a model for additional and more flexible processes to deal with MSME insolvency outside of the formal court system.

III. Institutional framework

9. It is noted in the Legislative Guide that designing an appropriate insolvency law requires consideration of the extent to which the courts will need to supervise the proceedings and whether or not their role can be limited with respect to different parts of the proceedings or balanced by the role of other participants. For example, an insolvency law could assign specific functions to other participants, or to some non-court authority such as an insolvency or corporate regulator.[9] This type of flexible approach could possibly be adapted to the context of MSME insolvency, and provide for a less formal, but nonetheless supervised, regime.

Part two: Core provisions for an effective and efficient insolvency law

I. Application and commencement

A. Eligibility and jurisdiction

10. The Legislative Guide sets out which debtors are eligible to be covered by an insolvency law. In doing so, it focuses on the conduct of economic activities by both legal and natural persons, regardless of the legal structure through which those activities are conducted, and would thus include all forms of MSMEs. In its discussion of the eligibility of natural persons engaged in economic activities, the Guide outlines a number of issues of particular relevance to MSMEs, including policies applicable to individual or personal debt and insolvency, the difficulty of

[7] UNCITRAL Legislative Guide, part one, chapter II, paras. 2-18.
[8] Ibid., paras. 37-38.
[9] UNCITRAL Legislative Guide, part one, chapter III, paras. 3-4.

discerning between business and consumer debt, and potential personal liability for debt incurred.[10] In terms of jurisdiction, the test for "centre of main interests" of the debtor is the debtor's registered office or, in the case of an individual, their habitual residence.[11]

B. Commencement of proceedings

11. The requirements for access to insolvency proceedings (and the type of proceeding that may be appropriate) may need to be considered in the context of MSMEs, as the burden of proving insolvency in order to commence insolvency proceedings may be too time-consuming and too expensive for MSMEs to meet and reorganization may only be possible where there is an early application. In addition, a balance sheet test of an MSME debtor's insolvency could be problematic given that a natural person's personal assets and liabilities may be mingled with those of the business. Further, when the business is doing poorly but the individual debtor is asset-rich, a balance sheet analysis could preclude access to insolvency proceedings or debt adjustment.[12]

12. Where creditors seek to commence insolvency proceedings in respect of a natural person engaged in an MSME, their incentive to do so will depend upon the ease with which debts are subject to collection outside of the insolvency context, and the extent to which discharge is available in the context of an insolvency proceeding. Where the MSME is run by a married couple, permitting them to apply to commence insolvency proceedings jointly may be appropriate to procedurally coordinate two related proceedings and facilitate distribution to joint creditors.

13. The Legislative Guide notes a situation that could be particularly relevant in the case of MSME debtors, that is, where there are insufficient assets to fund the administration of insolvency proceedings. In such cases, creditors may be reluctant to initiate proceedings or debtors may be loath to commence them, and some insolvency laws require the denial of an insolvency application when there are insufficient assets in the estate to fund the processes. The Guide outlines several different mechanisms for pursuing the administration of such estates, including levying a surcharge on creditors to fund the administration; establishing a public office or using an existing office; establishing a fund out of which the costs could be met; or appointing a listed insolvency professional on the basis of a roster or rotation system.[13]

C. Applicable law in insolvency proceedings

14. The applicable law in insolvency proceedings may have to be considered in certain MSME-specific contexts. In cases where a natural person engaged in an MSME has connections to two or more States, it may be uncertain which court is competent to adjudicate insolvency relief, which law should be applicable in the insolvency proceeding, and the circumstances pursuant to which a discharge of the debtor entered in one State will be enforced or recognized in another. In addition, the laws excluding certain assets from the insolvency estate may raise special

[10] UNCITRAL Legislative Guide, part two, chapter I, paras. 3-7 and recommendation 8.
[11] Ibid., para. 13 and recommendation 11.
[12] Ibid., paras. 25-26.
[13] Ibid., paras. 72 and 75 and recommendation 26.

problems, as some States view such laws as part of the insolvency law, while others consider such laws as a part of the broader procedural or collection laws applicable in an insolvency context.

II. Treatment of assets on commencement of insolvency proceedings

A. Assets constituting the insolvency estate

15. The Legislative Guide provides that the insolvency law may exclude certain assets from the estate, but notes that insolvency laws differ on this point. Where a natural person is the debtor, the excluded assets may include those necessary for the debtor to earn a living, as well as personal and household assets. These issues may be of particular importance to MSME debtors who may not own many assets in excess of the value of their homes.[14] States should be encouraged to specify the treatment of such assets. In addition, whether certain conduct on the part of the natural person, such as bad faith conduct, should affect the protected status of the exempted property might also be considered.

B. Protection and preservation of the insolvency estate

16. In light of the importance of personal guarantees in securing MSME debt, an issue for consideration might be whether an insolvency law should permit a court to extend the reach of a stay to protect the guarantor of an MSME debtor, as well as the circumstances of any such extension. This discretion could assist in the successful reorganization of MSMEs by staying the enforcement of such guarantees, which are often crucial to MSME financing, in appropriate circumstances.[15]

C. Use and disposal of assets

17. Where an MSME debtor is a natural person, the commencement of insolvency proceedings is likely to include both personal and business assets. Permitting the use of both types of assets in reorganization cases, and the use of personal assets even when the liquidation of business assets is certain might be considered,[16] with provision for the business assets to be sold before personal assets.

D. Post-commencement finance

18. Consideration might be given, in the situation where an MSME debtor is a natural person, to providing access to a credit card or other source of credit during the pendency of an insolvency or a debt adjustment proceeding.

E. Treatment of contracts

19. An additional issue for consideration might be the treatment to be accorded to covenants not to compete contained in partnership agreements or other contracts. In addition, provision for the distinct claims by and against partners in this context might be addressed.

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[14] UNCITRAL Legislative Guide, part two, chapter II, paras. 18-19 and recommendation 38.

[15] Ibid., paras. 30-34 and recommendations 46 and 48.

[16] Ibid., paras. 75-78 and recommendation 52.

F. Avoidance proceedings

20. An additional issue for consideration might be the circumstances pursuant to which avoidance of encumbrances on certain property exempt from the insolvency estate might be appropriate.

III. Participants

A. The debtor

21. The MSME context increases the importance of including the debtor in any insolvency proceeding, and particularly in a reorganization proceeding, so as to profit from the debtor's detailed knowledge of its business and the relevant market or industry, as well as its ongoing relationship with creditors, suppliers and customers.[17]

B. Insolvency representative

22. The means of payment of the insolvency representative can pose particular problems for MSME insolvencies, which may not have a large number of assets in the estate. The Legislative Guide outlines different approaches that can be taken to payment of the insolvency representative, noting that in situations where debtors have insufficient assets to pay for the administration of the estate, it may be possible to pay the insolvency representative from a fund maintained for that purpose by the State.[18]

23. Training specific to MSME insolvencies might be suggested for insolvency representatives, particularly where such enterprises play an important role in the economy and as a result of their nature may be more likely to require insolvency proceedings.

C. Creditors: participation in insolvency proceedings

24. In the case of MSME insolvencies, the debtor may be too small to justify the expense of establishing a creditor committee. In such circumstances, permitting the approval of debt adjustment plans without seeking creditors' votes on the proposal, but allowing creditors to appear as a party in interest with standing to object to the proposed plan might be considered.

IV. Reorganization

A. The reorganization plan

25. MSME owners that have the confidence of creditors are sometimes permitted and encouraged to retain some ownership interest in the debtor. Additional issues

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[17] UNCITRAL Legislative Guide, part two, chapter III, paras. 2-9 and recommendation 109, which states that the insolvency law should specify that the debtor is entitled to retain those assets excluded from the estate by the law. The World Bank Report on the Treatment of the Insolvency Natural Persons (2013) discusses extensively exemption policy, and could be considered in the context of possibly expanding upon recommendation 109. (To access the World Bank Report, see http://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf.)

[18] UNCITRAL Legislative Guide, part two, chapter III, para. 58 and recommendation 125.

that could be discussed in the MSME context could include permitting: (a) deviation from the absolute priority rule under limited circumstances; (b) MSME owners to have the exclusive right to propose a plan of reorganization for a limited period of time; and (c) owners of the MSME to remain as debtors in possession.

26. Time will be one of the most important factors in the reorganization of MSME debtors, both with respect to early application for reorganization and the length of time the process takes. The particular importance of incentives to encourage early filing might be emphasized. As to the conduct of the process, the Legislative Guide considers the issue of the setting of deadlines by which debtors must submit their reorganization plans, and recommends that a time period should be fixed by the insolvency law but that the court should be authorized to extend the time period in appropriate circumstances.[19] Time periods in the case of MSME debtors could be shorter than in the case of larger insolvencies, since MSMEs tend to have less complicated operations and financial arrangements and creditors might themselves be small businesses that cannot withstand long periods without payment during a reorganization process.

27. Without intending to dictate the contents of a plan of reorganization, basic forms to serve as templates for plans of reorganization for MSMEs might be provided.[20] In addition, less formal record-keeping and disclosure of information could be required of MSME debtors than is required of larger enterprises, and in light of the relative simplicity of MSME insolvencies, the need for transparency is reduced and an additional disclosure statement for creditors' review might not be required.[21] Multiple classes of unsecured claims may be unnecessary in most MSME reorganization plans, and in such cases, there may be no need for the insolvency law to provide for confirmation despite creditor dissent.[22] In addition, voting on an MSME plan of reorganization could be kept very simple, or could even be dispensed with in cases where the court is required to approve the plan according to a specific standard.[23] Secured creditors should be involved in any MSME reorganization, and bearing in mind the family nature of many MSMEs, the treatment of claims held by related persons might be dealt with in greater detail (see paras. 29 and 30 below).[24]

B. Expedited reorganization proceedings

28. In conjunction with the VRNs outlined above (see para. 7), the Legislative Guide advocates expedited reorganization proceedings as a means of limiting the costs and delays that can be associated with insolvency proceedings. Insolvency laws can include expedited proceedings in order to confirm VRNs; this additional speed and reduced cost could also be an advantage in the MSME insolvency context. Expedited proceedings could be examined for possible simplification for MSME insolvencies, for example, by doing away with court supervision of a

[19] UNCITRAL Legislative Guide, part two, chapter IV, paras. 15-16 and recommendation 139.
[20] Ibid., paras. 18-22 and recommendation 144.
[21] Ibid., paras. 23-25 and recommendation 141.
[22] Ibid., paras. 56-64 and recommendation 152.
[23] Ibid., paras. 26-51 and recommendation 145.
[24] Ibid., para. 46.

negotiated restructuring as long as a super-majority of creditors approve the agreement reached.[25]

V. Management of proceedings

A. Treatment of creditor claims

3. Verification and admission of claims

(f) Claims requiring special treatment

29. Subsection (ii) of this section of the Legislative Guide concerns creditor claims made by persons related to the debtor, whether in a familial or business capacity. For the reasons noted earlier (see para. 2), claims by related persons may be of particular importance in the MSME context. The Guide acknowledges that the mere fact of a special relationship is not sufficient in all cases to justify special treatment of a creditor's claim and that in some cases such claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons.[26]

B. Priorities and distribution of proceeds

1. Priorities

(c) Ranking of claims

30. Related to the discussion in the paragraph above is subsection (iv) of this section of the Legislative Guide, which concerns the ranking of claims made by persons related to the debtor, whether in a familial or business capacity. Some insolvency laws always subordinate such claims, while others subordinate such claims only on the basis of inequitable conduct or fraudulent or quasi-fraudulent conduct.[27] In the context of MSMEs, it may be desirable to consider in greater detail the question of guarantors of MSME debt.

C. Treatment of corporate groups in insolvency (and Part three: Treatment of enterprise groups in insolvency)

31. An issue that may arise in the context of MSMEs and the treatment of enterprise groups stems from the possible reliance of MSME debtors on a borrowing circle of individuals whose debts are connected to each other by cross-default provisions. The treatment of such "group debt" may need to be addressed in the MSME context.[28]

VI. Conclusion of proceedings

A. Discharge

32. The Legislative Guide notes increasing awareness of the need to recognize business failure as a natural feature of an economy and that several States have taken the view that their insolvency regime must also focus upon facilitating a fresh

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[25] Ibid., paras. 76-94 and recommendations 160-168.

[26] UNCITRAL Legislative Guide, part two, chapter V, para. 48 and recommendation 184.

[27] Ibid., para. 77 and recommendation 189.

[28] Ibid., paras. 82-92 and Part three: Treatment of enterprise groups in insolvency.

start for insolvent debtors by clearing their financial situation and taking other steps to reduce the stigma associated with business failure. The Guide contains detailed information in respect of discharge where the debtor is a natural person;[29] this information may need to be expanded in order to fully take into account the issue of MSME insolvency, particular where the MSME is conducted through a natural person. For example, it may be desirable to consider issues such as cross-border recognition of discharge (see also para. 14 above).[30]

II. MSME issues not currently considered in the Legislative Guide

33. The following issues are not currently addressed in the Legislative Guide and may be considered for further discussion in the MSME debtor context:

(a) Treatment of group debt (see para. 31 above);

(b) Debt adjustment mechanisms for natural persons to facilitate repayment of debt over time with the possibility of a discharge for debt that cannot be repaid over a defined period (e.g. 3 years);

(c) Possible approaches that could be taken to establish (or extend) informal insolvency processes; and

(d) Personal insolvency and whether appropriate mechanisms are necessary in order to adequately deal with MSME insolvency.

III. Issues for possible discussion

34. The Working Group may wish to consider the following non-exhaustive list of issues in its discussion:

(a) Does the Legislative Guide provide sufficient and adequate solutions for MSME insolvencies?

(b) If additional solutions are necessary, what form should they take? Could these solutions be addressed, for example, by extending the existing commentary or are additional recommendations required?

(c) Are there issues additional to those enumerated above that relate to MSME insolvency and are not currently addressed in the Legislative Guide? Should those issues be included in any additional work product? and

(d) Should any additional work required take the form of a further part of the Legislative Guide (e.g. part five) or a separate work product focusing on MSMEs?

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[29] UNCITRAL Legislative Guide, part two, chapter VI, paras. 4-13 and recommendations 194-196.

[30] Report of the 44th session of Working Group V, A/CN.9/798, para. 28.